COMPUTATION OF THE RATE OF INTEREST IN USURY CASES IN WHICH A BONUS IS EXACTED.

THE exaction of usury has ever been abhorrent to most courts; consequently they have been diligent in enforcing the laws limiting the rate of interest. This diligence has stimulated lenders to resort to various devices for the purpose of obviating the limitations imposed by law upon the taking of interest. Among the devices most commonly used for this purpose are: That the borrower shall assume and pay off the indebtedness of insolvents which he is under no obligation to pay; or purchase worthless property at an exorbitant price; or take out an insurance policy with the lender and pay the premiums thereon; or pay a bonus to the lender in addition to the highest rate of interest on the face of the loan.[1] In using such devices the lender generally exacts the bonus or other consideration at the time of making the loan and thereafter takes only the legal rate of interest upon the face of the loan. In determining the usurious nature of the transaction and the rate of interest actually exacted by the lender, it is important to have some definite rule for the computation of the rate of interest. This is especially important in cases involving the recovery of penalties imposed by law upon the lender for the taking of a usurious rate of interest, where such remedies must be resorted to within a prescribed time. For example, a federal statute[2] provides that the borrower may recover twice the greater rate of interest paid; provided the action for that purpose is brought within two years from the time of the occurrence of the usurious trans-

[1] 29 AM. & ENG. ENC. L. 510; 39 CYC. 985; Miller *v.* Life Insurance Co., 118 N. C. 612, 24 S. E. 484, 54 Am. St. Rep. 741; Phelps *v.* Montgomery, 60 Minn. 303, 62 N. W. 260; Bishop *v.* Exchange Bank, 114 Ga. 962, 41 S. E. 43; Ringer *v.* Virgin Timber Co., 213 Fed. 1001; Baker *v.* Lynchburg Nat'l Bank and Henry Silverthorn Jewelry *v.* Lynchburg Nat'l Bank (Va.), 91 S. E. 157. Attention is called to the fact that the highest legal rate of interest need not necessarily be exacted in connection with the bonus; since a lower rate together with the bonus may render the transaction usurious.

[2] U. S. Rev. Stat., § 5198; U. S. Comp. '16, §§ 9758, 9759.

action. Each payment of usurious interest is regarded as a usurious transaction within the meaning of this statute.[3]

It is characteristic of usury laws that the borrower must assert the remedies afforded against the usurious lender within a definitely fixed time. Unless this is done, all such remedies are lost. Now, when the borrower pays the bonus or the indebtedness of the insolvent and the highest legal rate thereafter on the face of the loan, does the statute run from the payment of this excess in addition to the regular rate of interest, or does it run from the time of each payment of interest? It is the purpose of this article to set forth the true rule for the computation of the rate of interest in those cases where a bonus has been exacted. As the same principles can be applied in those cases in which other devices are used, this discussion will be made more particularly with reference to the bonus cases, in order to avoid the confusion that might result from an effort to consider all at once.

In order to set forth the true rule more clearly, a definite set of facts will be used. They are as follows: In April, 1914, B wished to borrow $5,000. A agreed to lend B this money, provided he would pay a bonus of $500 in addition to the highest legal rate of interest—which will be taken as six per cent. per annum—on the face of the loan thereafter. This bonus was paid at the time of the loan, and six per cent. interest was paid on the face of the loan until April, 1917, the notes evidencing the indebtedness being renewed from time to time as they became due and the interest being paid at the time of each renewal. In April, 1917, an action was brought by B to recover twice the amount of interest paid within the two years prior to the bringing of his action. This action was based upon a right, given by a statute, to recover twice the amount of the greater rate of interest paid within the two years prior to the bringing of the action.[4]

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[3] McCarthy *v.* First Nat'l Bank, 223 U. S. 493.

[4] These facts are practically identical with those in Baker *v.* Lynchburg Nat'l Bank and Henry Silverthorn Jewelry Co. *v.* Lynchburg Nat'l Bank, *supra*. So far as the principles applicable are concerned, there is no substantial difference. These cases are taken up at greater length at another point, *infra*.

In order that B may recover, it must be shown that his right has not been barred by the statutes; in other words, that the subsequent payments of interest were affected with the usurious taint, notwithstanding the payment of the bonus or excess over the legal rate at the time of the making of the loan. Under the rule here evolved it will be shown that each payment of interest, subsequent to the time of the original loan, was actually at a greater rate of interest than six per cent.; unless matters of form are allowed to predominate over matters of substance, which is contrary to the spirit of usury laws.

That each payment of interest by B subsequent to the time of the original transaction was usurious is apparent from a consideration of fundamental principles of usury laws. It is established that a transaction usurious in its inception remains usurious until it is purged by a new contract, and that all securities however remote growing out of the original transaction retain the usurious taint.[5] Since the exaction of the bonus renders the transaction a usurious one, all the consequences attendant upon the exaction of usury flow therefrom until the transaction is purged by a new contract.

Even though the bonus exacted be regarded as a payment of interest for the loan, yet it is a part of the interest for the original loan until paid; and, taken in connection with the six per cent. —as it must be in order to determine the rate of interest received by the lender—there is no time in the life of the loan when A is not receiving a greater rate of interest than six per cent. Any argument that the payment of a bonus does not affect the subsequent renewals and the subsequent payments of interest is contrary to the spirit of usury laws; because, were that true, a means of evading the full force of such laws would thereby be given in the use of a mere matter of form. Let us take the example here used in connection with a statute providing for the recovery of twice the usurious interest paid within two years prior to the institution of the action for its recovery, and assume that the $500 bonus is a payment of interest in addition to the payment of six per cent. Should it be held that the $500 constituted the taint of usury in the transaction, and that it had no

[5] WEBB, USURY, § 308.

effect on the usurious nature of the remainder of the transaction, the borrower could recover under the above-mentioned statute only twice the $500. Had the lender exacted the same amount of interest as the $500 plus the six per cent. in the form of a specific rate of interest, or about $1100,[6] then the borrower could recover twice that amount, or $2,200, instead of twice $500, or $1000. Thus, a mere matter of form in the method of taking the interest would make a difference of $1,200 in the amount of recovery on the part of the borrower. If the $500 be regarded as interest, it is just as much for the use of the money lent through the entire time of the loan as that part of it reserved as six per cent. on the face of the loan; and the lender cannot purge the transaction by a separation into legal and illegal interest, in order to avoid the full effect of the law.

The confusion and errors in the decisions of the courts in such cases are due to a great extent to the use of the word "usury" in more than one sense. It is used to refer to the excess of interest exacted over the legal rate [7] and also to the taking of a greater rate of interest than is allowed by law. In the forego ing example, if the $500 be regarded as a payment of interest, it is the payment of the interest in excess of the regular rate of six per cent., and is referred to as the payment of the usury. Since this excess was paid at the time the loan was made, the erroneous assumption arises that there is no usury in the remainder of the transaction. So far as "usury" means the excess over the legal rate, that is correct; but this restricted meaning does not comprehend the fundamental meaning of the term. Usury is more properly defined as the taking of a greater rate of interest than is allowed by law.[8] When by his contract the lender exacts a greater rate than allowed by law, the transaction is a usurious one, and the taint of usury affects all interest until the transaction is purged by a new contract. Conse-

[6] Interest on $5,000 for one year at six per cent. is $300; so the amount for two years plus $500 would be $1100—nearly twelve per cent.

[7] See Baker *v.* Lynchburg Nat'l Bank and Henry Silverthorn Jewelry Co. *v.* Lynchburg Nat'l Bank, *supra.*

[8] This is the definition of Tyler, the leading text-writer on the subject. See TYLER, USURY 35.

quently, each payment of interest subsequent to the exaction of the bonus is a payment of usurious interest.

The difficulties and confusion arising from the employment of the word "usury" in more than one sense may be avoided by the application of the true rule of computation of interest where a bonus has been exacted. In the example used above, at the time the loan was made the lender retained a bonus of $500; or assume that B received the full $5,000, returning to the lender immediately or soon thereafter the $500 bonus and paying six per cent. interest on the face of the loan of $5,000 whenever the interest became due. It is evident that the real substance of this transaction is that B received as a loan only $4,500, and paid interest at the rate of six per cent. on the $5,000, or $300 annually; while six per cent. on $4,500 would be only $270. In other words, B really had the use of a loan of $4,500, on which he paid interest at the rate of over six and one-half per cent. per annum. Or again, if the lender retained the sum of $1,000 out of the loan as a bonus, or had that sum paid or returned to him immediately or soon thereafter, B in reality would have had the use of a loan of $4,000 while paying interest on a loan of apparently $5,000. It is quite obvious that each payment of interest, though at the legal rate on an apparent loan of $5,000, was in fact at a greater rate on an actual loan of $4,000. By the very terms of the agreement, the borrower was to have the use of only $4,000, instead of $5,000; so, the substance of the transaction was a loan of $4,000, though the form was different. To show the extent of the application of this rule, assume that the lender charges only five per cent. on the face of the apparent loan of $5,000 in addition to the $1,000 bonus. By this method of computation, it is evident that the lender is still getting nearly six and one-half per cent. on the actual loan of $4,000.

From this example the abstract rule is readily deducible that when a bonus is exacted of the borrower by the terms of the agreement, the bonus must be deducted from the face of the loan as of the date when it is payable, and the computation of interest must be made on the remainder, in order to ascertain the ac-

tual rate of interest received by the lender.[9] An exaction by the lender of a bonus or other consideration in addition to the highest legal rate of interest reduces the contract essentially to a loan of the difference between the apparent face of the loan and the bonus. In other words, an agreement by A to lend B $5,000, provided B will pay a bonus of $500, or pay indebtedness of $500 owed by an insolvent to A, or render services to A worth $500 in addition to paying six per cent. interest on the apparent face of the loan, is essentially an agreement for the loan of $4,500 to B. B has the actual use of only $4,500 throughout the period of the loan, and of course that amount should be taken as the basis of the computation of the rate of interest received by A.

This rule was applied in the early English case of Scurry *v.* Freeman.[10] In that case an agreement was entered into in 1794 between A and B, whereby A lent B five hundred pounds, apparently at the regular rate of interest; but it was understood between the parties that A should have something more than legal interest as his compensation. On the afternoon of the same day on which the loan was made B paid over fifty pounds to A's son, who was designated to receive the bonus. B paid the regular rate of interest on five hundred pounds until 1797. At that time the securities were changed, but B continued paying interest at the same rate until 1799. In order to recover the penalty under the English law at that time, it was necessary to institute the action within one year from the last usurious payment. It was contended that the crime of usury was complete in September, 1794, on the receipt of the fifty pounds bonus given as extra compensation; but the court held that, as the borrower had in fact received a loan of only four hundred and fifty pounds, every payment of interest on the five hundred pounds was usurious, and that the statute of limitations began to run from the date of the last payment in 1799 rather than from the date of the return of the fifty pounds in 1794. This is a common sense rule. If A computes interest

[9] 29 AM. ENC. ENC. L. 495; Oyster *v.* Longnecker, 16 Pa. St. 269; Scurry *v.* Freeman, 2 Bos. & Pul. 381; Smith *v.* Parsons, 55 Minn. 520, 57 N. W. 311; Hutchinson *v.* Herrick, 58 Minn. 453, 59 N. W. 1103.

[10] *Supra.*

at the rate of six per cent. on $5,000 when in fact B had the use of only $4,500, it cannot be denied that each payment of interest was at a greater rate than six per cent.

It is to be noted than an effort was made in the above case to confuse the court by the use of "usury" in the sense of the excess over the legal rate of interest; but the court did not lose sight of the true underlying principle of usury, that when once the transaction has been made usurious, it remains affected by the taint until purged by a new contract. The rule of computation herein contended for merely demonstrates the reason of that fundamental principle of usury laws.

This rule has been recognized and followed in the more recent case of Smith *v.* Parsons.[11] In that case, Smith contracted with Parsons for a loan of $20,000 for five years, Smith agreeing to pay seven per cent. interest on the face of the loan and, in addition thereto, to pay Parsons a bonus of $1,000 and to render certain services of the value of $500, thus making a bonus of $1,500. The loan was to be turned over to Smith in installments. The highest rate of interest allowed under the laws of Minnesota was ten per cent.; so it is evident that it was necessary to apply some general rule of computation in order to determine whether the lender exacted more than ten per cent. interest from the borrower. The court applied the rule herein set forth, that when by the terms of the agreement a bonus is exacted from the borrower, the amount of the bonus must first be deducted from the apparent face of the loan, as of the time when it is payable, and the computation of interest made on the remainder; and that, where a bonus is taken as additional consideration for making a loan, it is in substance an agreement to lend the difference between the two sums.

In the recent cases of Baker *v.* Lynchburg National Bank and Henry Silverthorn Jewelry Co. *v.* Lynchburg National Bank[12] the Supreme Court of Appeals of Virginia refused to follow this rule. These cases arose under §§ 5197, 5198 of the United States

[11] *Supra.* See also, Oyster *v.* Longnecker, *supra;* Hutchinson *v.* Herrick, *supra.* By this method of computation it was found that less than the legal rate of interest had been taken.

[12] *Supra.*

Revised Statutes. The former section provides that a national bank may charge the rate of interest allowed by the laws of the state in which it is located; and the latter section provides that, where the borrower has paid a greater rate of interest than allowed by the laws of the state of location, he may recover twice the greater rate of interest paid, provided the action to recover the penalty "is commenced within two years from the time the usurious transaction occurred." It is settled that each usurious payment of interest constitutes a usurious transaction within the meaning of the above statute.[13]

The facts in these cases were as follows: In March, 1911, the bank agreed to lend Baker $6,730.00, provided he would assume an indebtedness of $930.11 owed to the bank by an insolvent—which indebtedness Baker was under no obligation to pay —and pay six per cent. interest on the face of the loan of $6,730.00. Accordingly, the loan was made; Baker paid the indebtedness of $930.11; and from time to time, as the notes evidencing the indebtedness became due, paid interest at the rate of six per cent. In 1914, Baker brought an action to recover, under § 5198, twice the amount of interest paid within the two years prior to the institution of his action. The court held that Baker was not entitled to recover anything; because the right of action was barred by reason of the payment of the $930.11 over three years prior to the institution of the action for the recovery of the penalty. Since all payments of interest subsequent to the payment of the $930.11 were apparently at the legal rate, the court was of opinion that there were no usurious payments of interest within the two year period.

This decision exemplifies the use of the word "usury" as meaning excess over the legal rate of interest,[14] rather than as meaning the taking of a greater rate of interest than allowed by law. The effect of this decision is that the creditor may, by

[13] McCarthy *v.* First Nat'l Bank, *supra.*

[14] Judge Sims, in delivering the opinion of the court, said (at p. 165): "The $930.11 was a payment made by the debtor in the instant case to be applied, and it was in fact applied by the creditor, to the payment and discharge of the only usury that was in fact charged by the creditor or paid by the debtor."

taking the excess over the legal rate in the form of a bonus and reserving the legal rate on the face of the loan, purge the remainder of the transaction of the taint of usury,, which is contrary to established principles. It is the taking of the bonus in addition to the highest rate that renders the transaction usurious, and the whole transaction and every payment of interest is affected with the taint until the transaction is purged by a new contract. Regarding the $930.11 as a payment of interest, it must be taken in connection with the subsequent payments of interest in order to determine the rate of interest paid. Applying, however, the proper rule for the computation of the rate of interest in such cases, it is evident that by the terms of the agreement Baker had the use of only $6,730.00 less $930.11, or $5,800.00, throughout the life of the loan; and the amount actually had for use must be taken as the basis of computation of the rate of interest actually received by the bank. Since Baker paid interest at the rate of six per cent. on the apparent face of a loan of $6,730.00, and yet had the use of only $5,800.00, he actually paid interest at the rate of about seven per cent. for the money used. Consequently, each payment of interest subsequent to the exaction of the $930.11 bonus was at a greater rate than that allowed by law; and therefore each payment was a usurious one.

As has been suggested above, however, whether this rule is followed in this class of cases or not, it is evident that each payment of interest subsequent to the execution of the loan, for which a bonus is exacted in addition to the highest legal rate of interest, is usurious, *i. e.*, the rate is greater than that allowed by law. At the time of each subsequent payment, some interest has already been taken for the use of the money throughout the period of the loan, and in addition to that, six per cent. is taken at each subsequent payment, thus making the rate of interest in each case greater than six per cent. If the bonus exacted can be regarded as interest, instead of a reduction of the principle, it is far more consonant with reason and law to regard the first interest taken as the interest allowed by law, and all taken after that rate is reached as the excess above the legal

rate. It is submitted, however, that the logical rule based upon reason, law and authority is that which regards the difference between the bonus and the apparent face of the loan as the actual amount of the loan and computes interest with reference to the amount actually had for use by the borrower.

Clarence O. Amonette.

LYNCHBURG, VA.